a shift of costs to the intrastate jurisdiction. Whatever the merits of the original decision, it was overturned for this "pure policy" reason.

2. **Billing Inquiry Services**

In 1984, the New York Public Service Commission alerted the FCC and the Joint Board that, under the separations rules then in effect, AT&T's assumption of billing inquiry services previously provided by the LECs would cause a sudden and substantial reassignment of Account 645 costs to the intrastate jurisdiction.

Prior to that time, LECs performed the billing and collection, including billing inquiry services, for both local telephone service and long distance toll calling carried over AT&T's network. This reassignment was caused by the fact that under these rules, the level of Account 645 costs assigned to the interstate jurisdiction was largely a product of the customer contact factor.[57/] However, responding to end user billing inquiries involved a very small portion of local commercial work time.[58/] Moreover, the interstate customer contact factor had been developed from a formula based on relative revenues rather than the use of actual accounts or samples of contacts.[59/] Thus, AT&T's provision of its own billing inquiry service would reduce the number of local commercial office contacts related to interstate toll messages, thereby lowering the interstate cost assignment, without producing

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57/ The customer contact factor is the relative number of business office contacts relating to state toll and interstate toll messages and was used as the allocation factor under the separations rules in effect at that time.

58/ *See MTS and WATS Market Structure*, Memorandum Opinion and Order, 1 FCC Rcd. 1216 at para. 3 (1986).

59/ *See* MTS and WATS Market Structure, 60 Fed. Reg. 2d 1345 at para. 12 (1986).

an offsetting reduction in total local commercial office costs. The jurisdictional shift was far in excess of the costs that LECs would save by discontinuing their billing inquiry service and underscored the jurisdictional allocation of costs that had been produced by the then existing separations procedures.[60] The Joint Board and the FCC acknowledged that excessive Account 645 costs had been allocated to the interstate jurisdiction, but in light of the potentially abrupt jurisdictional shift, decided that, as an interim measure until permanent measures for the allocation of Account 645 were adopted, the interstate allocation of these costs should be frozen and then gradually phased down over a twelve month period to approximately one-half of the preexisting level. The affected BOCs were ordered to adjust their access charge tariffs to reflect these changes. These tariffs were later allowed to go into effect over the objections by AT&T that the BOCs had allegedly failed (1) to reduce their billing and collection rates to reflect correctly the transfer of certain costs from preexisting billing and collection rate elements to the new interim traffic-sensitive rate element, and (2) to comply with the phased down Account 645 and related costs assigned to the interstate jurisdiction.[61]

As a consequence, although acknowledging that Account 645 allocated a disproportionate amount of costs to the inflated interstate jurisdiction, the FCC and Joint

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[60] The Joint Board; MTS and WATS Market Structure, Mimeo No. 3400 (rel. March 25, 1985), 50 Fed. Reg. 14729 (April 15, 1985); and the FCC MTS and WATS Market Structure, 50 Fed. Reg. 26204 (June 25, 1985), *recon.*; 60 Fed. Reg. 2d 1345 (adopting the Joint Board's recommended interim separations procedures); *MTS and WATS Market Structure*, Decision and Order, FCC No. 865 (rel. January 7, 1986); 51 Fed. Reg. 3176 (January 24, 1986), *recon.*; 1 FCC Rcd. 1216 (adopting the Joint Board's reasoning for such procedures).

[61] *New England Telephone and Telegraph Company, et al.*, Order, 1986 FCC LEXIS 2932 (rel. August 5, 1986).

Board perpetuated it for at least a year thereafter. Even when the FCC eventually adopted permanent changes to the allocation of Account 645 expenses,[62] it anticipated that these new separations procedures would decrease, but not eliminate, the inflated interstate allocation of Account 645.[63] Even in the midst of the separation reforms, the Joint Board and the FCC were very much aware of, and always discussed and considered, the potentially adverse policy ramifications of moving too many dollars to the intrastate jurisdiction.

3. Local Dial Switching Equipment

For purely pragmatic reasons, the FCC and Joint Board were extremely reluctant to include the costs of subscriber plant in the subscriber line charge. A classic example of that reluctance was the separations and access charge treatment of Local Dial Switching Equipment.[64]

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[62] *See*, 60 Fed. Reg. 2d at n. 22. The rules became effective on January 1, 1987. They were originally due to become effective on June 1, 1986. 51 Fed. Reg. 3176. In 1986, the FCC preemptively detariffed the LECs' provision of billing and collection for unaffiliated interexchange carriers. In 1987, the FCC decided to continue to apply the jurisdictional separations process to billing and collection service costs to identify investment and expenses that are properly attributable to intrastate activity. It anticipated that the detariffing of billing and collection would not shift costs between the state and interstate jurisdictions, but that it would merely remove some interstate costs from the regulated arena. Detariffing of Billing and Collection, 102 FCC 2d 1150 at para. 48 (1986).

[63] *See*, 60 Fed. Reg. 2d at para. 21. Retention of the Local Subsidy.

[64] Examples of Local Dial Switching Equipment include basic switching train, toll connecting trunk equipment, inter-local trunks, tandem trunks, terminating senders used for toll completing, toll completing trains, cal reverting equipment, weather and time of day service equipment, concentration equipment, and switching equipment at electronic-analog or digital remote line locations. *See, Amendment of Part 67*, Recommended Decision and Order, 2 FCC Rcd. 2551 at para. 3 (1987).

Under the former Part 67 separations procedures, carriers were required to divide their investment in the former Category 6 Central Office Equipment (COE), Local Dial Switching Equipment, into non-traffic-sensitive and traffic-sensitive components. The non-traffic-sensitive component was allocated on the basis of the frozen SPF, whereas the traffic-sensitive component was allocated on the basis of dial equipment minutes (DEM), which included toll weighing factors (TWFs).[65/] Under the former Part 69 rules, carriers were required to apportion costs between three end office elements: Line Termination, Local Switching, and Intercept.

Local Switching was divided into two sub-elements: Local Switching 1 ("LS1") and Local Switching 2 ("LS2"). The former Line Termination and Local Switching elements reflected the classification of the former Category 6 COE, Local Dial Switching Equipment, into traffic-sensitive and non-traffic-sensitive portions for jurisdictional separations purposes. The differences in the former LS1 and LS2 sub-elements of the Local Switching element reflected the TWFs applied to toll minutes for the purpose of allocating the traffic-sensitive portion of the former Category 6 COE.

Effective January 1, 1988, the FCC revised the Separations Manual, pursuant to Joint Board recommendations, to consolidate the former Category 6 COE, Local Dial Switching, with other switching categories to form a new category, COE Category 3, Local Switching Equipment.[66/] This new category was allocated between the jurisdictions on the basis of

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65/ TWFs were intended to reflect the then higher cost of usage of the switch by toll calls, which are trunk side connections, rather than local calls, which are line side connections.

66/ The former COE categories included: Category 4, Automatic Message Recording Equipment; Category 5, Other Toll Dial Switching Equipment; and Category 7, Special Services Switching Equipment.

DEM. In other words, the FCC eliminated the traffic-sensitive/non-traffic-sensitive distinction applicable to Local Switching Equipment, allocating on a relative usage basis as though such costs were all traffic-sensitive, which they were not. Most LECs supported this change as a warranted simplification of the separations process.

The FCC believed that because digital switching equipment was presumably comprised mainly of traffic-sensitive components, a flat allocation factor would be inappropriate.[67] The FCC also eliminated the use of TWFs and the LS1 discount on the assumption that with the use of modern switches, use of the switch for toll calls is no longer more costly than for local calls.[68]

The LECs were also required to phase in the DEM allocation factor over the 1988-1992 period in order to forestall substantial shifts in costs from the interstate jurisdiction to the state jurisdiction which were anticipated if the new procedures were implemented on an immediate basis.[69] While eliminating the traffic-sensitive/non-traffic-sensitive distinction and allocating all Local Switching Equipment as if it were traffic-sensitive has simplified the interstate treatment of such equipment, such changes have also created an uneconomic recovery mechanism. (by recovering non-traffic-sensitive costs on a traffic-sensitive basis). It was believed that the benefits of simplicity were more important than economic efficiency.

67/ 3 FCC Rcd. 5518 at para. 49.

68/ *See, e.g.*, 4 FCC Rcd. 765 at para. 7 (1988).

69/ On the access charge side, the FCC combined Line Termination, LS1 and LS2, into a single access element that was assessed on the basis of unweighted access minutes. The FCC also established a transition mechanism to eliminate the rate differential between the LS1 and LS2 sub-elements.

Moreover, the combining of COE categories and the five year phase-in perpetuated what the FCC considered to be an overallocation to the interstate jurisdiction. Over time, it has become increasingly clear that the non-traffic-sensitive portion of Local Switching Equipment is greater than was publicly predicted by the FCC and the Joint Board. Indeed, technical advances in local dial switching have increased the amount of non-traffic-sensitive switching costs currently being recovered in Local Switching rates. Recent studies performed within NYNEX using switch vendor-provided information and considering other usage and size parameters provided by NYNEX traffic engineers, reflect that the average percentage non-traffic-sensitive costs range from 6 percent for analog electronic switching systems to an average of 51 percent for the most modern digital systems. Whereas the determination of which size switch to install is clearly a traffic-sensitive decision,[70/] a local switch exhibits many of the same cost factors as non-traffic-sensitive local loop;[71/] once it is installed, the switch incurs virtually no additional costs based on the traffic it handles, within reasonable ranges.

Moreover, the non-traffic-sensitive portion of such equipment is used to support the local loop, not the provision of carrier access services. The only reason such costs were excluded from the subscriber line charge was because, at that time, the FCC was in the midst of a controversy of attempting to recover, for the first time, any costs directly from end user subscribers. To have proposed increasing the subscriber line charge to include recovery of

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70/ "Even if virtually all switching costs become fixed when the switch is installed, the decision to install a large switch rather than a small switch or to install five switches rather than four is affected by the anticipated traffic volume." 3 FCC Rcd. 5518 at para. 47.

71/ The non-traffic-sensitive portion of the local switch is a function of the number of loops it supports, not the volume of traffic.

local switching could have jeopardized the entire subscriber line charge effort because of fears that customers would become overburdened with interstate costs, which ultimately could harm universal service. While the political decision to exclude local switching costs from the subscriber line charge was arguably justifiable at the time the decision was made, this issue warrants reexamination by a Joint Board. In a competitive environment, attempting to recover the costs of subscriber plant through loadings may not be sustainable in the future.

4. Interexchange Circuit Equipment and Cable and Wire Investment

Part 36.126 of the Commission's rules currently requires that LECs' interexchange trunk investment be assigned to the message joint, interstate private line, and intrastate private line subcategories, and that these costs be allocated among these subcategories on the basis of "termination counts."[72] Similarly, Part 36.156(a) of the Commission's rules requires that Category 3 interexchange cable and wire costs be assigned to the above subcategories, and that these costs be allocated based on the average cost per equivalent telephone circuit kilometer. [73] Part 36.156(b) requires that the cost of cable and wire facilities attributable to this category be assigned directly where feasible.[74]

It is possible, in the course of developing basic cost studies, to directly identify the interexchange circuit equipment, cable, and wire costs associated with each subcategory,

[72] 47 C.F.R. § 36.126.

[73] 47 C.F.R. § 36.156(a).

[74] 47 C.F.R. § 36.156(b).

except message joint. Direct assignment of these costs would be appropriate, since all categories of interexchange cable and wire investment and interexchange circuit equipment (except message joint) are jurisdictionally pure. A core principle of the separations process is that direct assignment, where feasible, is superior to the use of broad allocators. If direct assignment were used for these costs, it would be necessary to continue using traffic usage factors to determine the jurisdictional allocation within the message joint subcategory.

Moreover, if the majority of interexchange circuit equipment cable and wire facilities costs were allocated directly, with only a small portion of costs allocated based on traffic usage factors, this would result in a significantly lower allocation of such costs to the interstate jurisdiction than under the current rules. Specifically, for all LECs, the amount of interexchange circuit equipment costs allocated to the interstate jurisdiction would be approximately $197 million lower than under the current methodology. Likewise, an analysis of certain LECs' cable and wire costs, extrapolated to the entire industry, suggests that approximately $23.5 million less of the LECs' combined interexchange cable and wire costs would be allocated to the interstate jurisdiction. These figures further support the proposition that the costs currently allocated to the interstate level, and recovered through interstate rates, reflect policy decisions and not necessarily the LECs' actual costs of providing interstate services.

IV. **Conclusion**

For decades, the Commission, in conjunction with state regulators, has established policies deliberately designed to recover the LECs' non-traffic-sensitive network costs from both the interstate and intrastate jurisdictions. Even when significant changes were made to the separations process in the 1980s, the FCC and the Joint Board were well aware that large amounts of interstate non-traffic-sensitive and other costs would continue to exist at the end of that set of reforms. These changes in the separations process were part of a deliberate attempt by decisionmakers to advance various political and policy goals rather than merely to foster economically efficient pricing:

> [Any characterization of separations as] a small, technical process of no particular importance . . . is a totally untenable position. The rapid growth of separations charges could not have escaped the attention of even the densest regulator. Everyone connected with telecommunications . . . knew that local telephone service was being supported more and more by revenues from interstate traffic. Anyone who thought about the amount of money involved must have understood that this was hardly the unintended fallout of a jurisdictional decision in 1930. It was instead the result of an ongoing political process . . . .[75]

This history holds important lessons in the context of the Telecommunications Act of 1996 and the Commission's access charge reform initiative. In particular, it explains why current access charges are set well above the pure economic cost of providing access services. These rates reflect a whole series of deliberate policy decisions to move certain costs to the interstate jurisdiction or leave them there when it was no longer logical or economically efficient to do so.

The purpose of these decisions primarily was to reduce upward pressure on local telephone service rates and thereby maintain universal service goals. These goals were largely accomplished by the policies of the FCC and Joint Board in the separations process. The allocation of a significant portion of LECs' non-traffic-sensitive costs and other joint and common costs to the interstate jurisdiction, and the requirement that these costs be recovered

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[75] Temin at 358.

through interstate access charges, currently are legal requirements imposed by the government, in furtherance of its policy objectives.[76]

In the *Access Reform NPRM*, the Commission takes an important step -- but only a first step -- towards addressing the cost recovery issue, by clearly acknowledging the legacy of separations policy decisions and by addressing some of the implications for access charge reform. For the first time in a Commission order, the agency recognizes the legal and practical necessity of permitting LECs to recover their prudent and reasonable actual costs of operation. At the same time, however, the Commission fails fully to appreciate the implications of proposals in the *Notice*. To the extent the FCC decides to adopt rules that will drive access rates down to the incremental cost of providing access, it must recognize and resolve the cost recovery issues raised by its own past policies. And that is exactly what would happen under either of the access reform options discussed in the *Notice*, or any combination of the two options. It would occur directly under the prescriptive approach, but just as inevitably under the market-based approach. Since other carriers would be free to purchase the network elements necessary for interstate access from the LECs, at the elements' incremental cost, the LECs would have no choice but to lower their access rates. That would create a revenue shortfall. Recovering the shortfall by raising local rates or rates for other intrastate services is not an option, since it is prohibited under the separations rules.

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[76] There is nothing inherently wrong with a policy-based division of plant cost between the jurisdictions. In a regulated environment, any allocation of non-traffic-sensitive plant is certain to reflect, in large measure, policy views. There is, of course, no greater economic rationale for a SLU-based division of such plant cost than for a division based on a flat allocator chosen by the regulator.

In fact, the most important and relevant policy determination is the division between the portion of non-traffic-sensitive cost charge end-users and the portion charged to others -- a determination that is made separately at both the federal and state levels.

Thus, unless a new mechanism were established to recover the shortfall, the LECs' only other option would be to recover as much of the shortfall as possible by increasing their rates for interstate services that are least subject to competition. Such pricing distortions would simply perpetuate the inefficiencies the Commission is seeking to eliminate.

Accordingly, the FCC must establish a mechanism or mechanisms for the LECs to recover the difference between the costs they are required to allocate to the interstate jurisdiction and the revenues they will generate under the new access pricing rules. To fail to provide for their recovery would raise significant legal issues and violate the basic social compact under which the telecommunications industry has operated and related to its regulators for over 60 years. A fundamental tenet of that compact has been that if the government decides by regulatory fiat to shift to the interstate jurisdictions costs a LEC actually incurs in providing intrastate services, the LECs will be able to recover these costs at the interstate level.

The legal and constitutional principles governing the cost recovery issue are clear. The rates set by regulators for a LEC's services must be sufficient to provide a reasonable return to investors.[77/] To satisfy this standard, rates set by regulators must provide "enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stocks."[78/] Further, the

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[77/] *See, e.g. Bluefield Water Works and Improvement Co. v. PSC of West Virginia,* 262 U.S. 679 (1923); *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n of Missouri*, 262 U.S. 276 (1923); *Smyth v. Ames*, 169 U.S. 466, 546 (1898); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168 (D.C. Cir. 1987).

[78/] *See Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1994) at 603.

return that is the end result of the rate-setting process "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[79] Rates that are not sufficient to yield a reasonable return for the regulated entity are "unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.[80] The Commission has flexibility in determining how the costs assigned to the interstate jurisdiction will be recovered. That is, it can and does determine which services and rates will be used to recover what share of the interstate costs. But the above-cited precedents establish clearly that the combined revenues from the LECs' interstate services must be sufficient to recover the LEC costs assigned to the interstate jurisdiction.

If the Commission adopts new rules that result in incremental cost-based rates (either directly through prescription of such rates or indirectly through adoption of the market-based approach), the LECs' interstate access rates no longer will be sufficient to recover the costs assigned to the interstate jurisdiction. The legal precedents governing cost recovery instruct the Commission, in such circumstances, to provide some other means to recover the difference.[81]

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[79] *Id.; see also Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n,* 810 F.2d 1168 (D.C. Cir. 1987) at 1176.

[80] *See Bluefield Water Works,* 262 U.S. at 690; *see also Duquesne Light,* 488 U.S.

[81] If future intestate access rates are insufficient to recover the costs assigned to the interstate jurisdiction, the unrecovered costs will effectively be stranded. Some advocates have argued, incorrectly, that *Duguesne Light Co. v. Barasch* (488 U.S. 299 [1989]) and other Supreme Court cases stand for the principle that a utility's "losses due to competition are not recoverable." *See, e.g.* K.Rose, *An Economic And Legal Perspective On Electric Utility Transition Costs* (Nat'l Reg. Research Inst., Jul. 1996) ("NRRI Electric Transition Costs Paper") at 59-61. Even if this interpretation were correct -- which it is not -- it clearly
(continued...)

It is also important to note that reform of the separations process is unlikely to resolve the problem of how to provide for the recovery of prudently incurred LEC costs. To the extent that any states adopts pricing rules comparable to those the Commission proposed to use in pricing of network elements -- i.e., based on incremental costs -- it will not be possible for LECs in those states to recover any costs that may be reallocated (through reform of the separations process) to the intrastate jurisdiction. Just as incremental cost pricing of network elements at the interstate level would force the LECs to set their interstate access rates at incremental cost levels, incremental cost-based pricing of network elements at the intrastate level would force the LECs to do likewise with respect to intrastate services. The LEC must compete with carriers that purchase network elements from the LEC. The prices it charges for its services will tend to be forced toward the prices it is required to charge competitors for the network elements used to provide a given service.

Indeed, through numerous Commission and state regulatory proceedings, the LECs are being required to price an increasing number of services at their incremental costs. Service after service is being foreclosed as a means for the LECs to recover the difference between incremental costs and the actual costs of operation that they prudently incur. Yet the LECs have the legal right to recover these reasonable costs. What is required is a carefully coordinated approach to ensure the recovery of these costs in a rational and

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[81/](...continued)
does not apply to the cost recovery issue discussed in this affidavit. The losses LECs would incur if the Commission drives access rates toward the incremental cost of providing interstate access would not be due to competition, but rather to regulation. Unless the Commission provides a mechanism to recover the difference between the LECs' access revenues under the rules and their costs assigned to the interstate jurisdiction, an unconstitutional confiscation of LEC property will result.

economically efficient manner that furthers the Commission's -- and Congress' -- pro-competitive goals for the telecommunications sector. At the interstate level, that means that the Commission must adopt a coherent set of rules governing the recovery of costs allocated to the federal jurisdiction. In particular, this requires the establishment of a mechanism to recover the difference between the revenues the LECs will generate from interstate access services, following access charge reform, and their prudently incurred costs assigned to the interstate level.

V. About the Authors

James M. Fischer

Mr. Fischer is an attorney in private law and regulatory consulting practice in Jefferson City, Missouri. Prior to entering private law practice in January, 1990, Mr. Fischer served for six years as a Commissioner and Vice-Chairman of the Missouri Public Service Commission. He served on the National Association of Regulatory Utility Commissioners (NARUC) Communications Committee, serving as its Litigation Task Force chairman. He was a member of the Federal-State Joint Boards in CC Docket Nos. 80-286 and 85-124 dealing with numerous separations issues as well as the FCC's Joint Conference on Open Network Architecture. He also served as a member NARUC's Task Force on Cable Television/Telco Cross-Ownership.

Mr. Fischer also represented the states and NARUC in oral arguments before Judge Green concerning the line of business restrictions on the Regional Bell Operating Companies during the first triennial review of the AT&T Modified Final Judgment.

Prior to his appointment to the Missouri Public Service Commission, Mr. Fischer served as the Public Counsel for the State of Missouri from 1981 to 1984. From 1976 to 1981, he was an Assistant Public Counsel in that office.

Mr. Fischer was raised in Raytown, Missouri and graduated from the University of Kansas in 1973 majoring in Economics and Political Science. He received his law degree from KU in 1976, where he was an associate editor of the Kansas Law Review.

Albert P. Halprin

Albert Halprin is a Partner with the law firm of Halprin, Temple, Goodman & Sugrue. From 1980 to 1983, he was a Staff Attorney and then Chief of the Plans and Policy Programming Division at the FCC, during which time he was intimately involved with separations matters. He was Chief of the Common Carrier Bureau between 1984 and 1987, during which time he had firsthand experience with many of the separations matters described herein.

Henry M. Rivera

Henry M. Rivera is a Partner with the law firm of Ginsburg, Feldman & Bress. From 1981 to 1985, Mr. Rivera was a Commissioner at the Federal Communications Commission, and in that capacity served as a member of the Federal/State Joint Board on Separations Issues.

Mr. Rivera is the past president of the Federal Communications Bar Association, a Fellow of the American Bar Foundation, Vice Chairman of the Foundation for Minority Interests in Media, a member of the boards of the Benton Foundation, Questar, Inc., and Issue Dynamics, Inc.

Marvin R. Weatherly

Marvin R. Weatherly served as a commissioner and chairman of the Alaska Public Utilities Commission from 1975 until his retirement in 1987. Commissioner Weatherly was a member on four Federal/State Joint Boards. He served on the NARUC Communications Committee from 1978 to 1987. During this period Weatherly gave special attention to policy questions of universal-telephone service and small telephone company operations.

He is currently semi-retired and does consulting work for domestic and international companies.

ATTACHMENT 3

AFFIDAVIT OF
J. GREGORY SIDAK AND DANIEL F. SPULBER

USTA COMMENTS
CC DOCKET NO. 96-262
JANUARY 29, 1997

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
Usage of the Public Switched Network by Information Service and Internet Access Providers	)	CC Docket No. 96-263

AFFIDAVIT OF
J. GREGORY SIDAK AND DANIEL F. SPULBER

J. Gregory Sidak and Daniel F. Spulber, being duly sworn, depose and say:

1. My name is J. Gregory Sidak. I am the F. K. Weyerhaeuser Fellow in Law and Economics at the American Enterprise Institute for Public Policy Research (AEI), where I direct AEI's Studies in Telecommunications Deregulation. I am also a senior lecturer at the Yale School of Management, where I teach a course on telecommunications regulation with Professor Paul W. MacAvoy. I served as Deputy General Counsel of the Federal Communications Commission from 1987 to 1989, and as Senior Counsel and Economist to the Council of Economic Advisers in the Executive Office of the President from 1986 to 1987.

2. My academic research concerns telecommunications regulation, antitrust policy, and constitutional law issues concerning economic regulation. I have written four books concerning pricing, costing, competition, and investment in regulated network industries: *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* (Cambridge University Press, forthcoming 1997), co-authored with Daniel F. Spulber; *Toward Competition in Local Telephony* (MIT Press & AEI Press 1994), co-authored with William J. Baumol;

Transmission Pricing and Stranded Costs in the Electric Power Industry (AEI Press 1995), also co-authored with William J. Baumol; and *Protecting Competition from the Postal Monopoly* (AEI Press 1996), also co-authored with Professor Spulber. I am also the author of a fifth book, *Foreign Investment in American Telecommunications* (University of Chicago Press, forthcoming 1997), and of more than twenty-five scholarly articles in the *Journal of Political Economy*, *California Law Review*, *Columbia Law Review*, *Cornell Law Review*, *Duke Law Journal*, *Georgetown Law Journal*, *Harvard Journal on Law & Public Policy*, *New York University Law Review*, *Northwestern University Law Review*, *Southern California Law Review*, *Yale Journal on Regulation*, and elsewhere. I am the editor of *Governing the Postal Service* (AEI Press 1994). I have testified before the U.S. Senate and House of Representatives, and my writings have been cited by the Supreme Court, by the lower federal courts, by state and federal regulatory commissions, and by the Judicial Committee of the Privy Council of the House of Lords. I have been a consultant on regulatory and antitrust matters to the Antitrust Division of the U.S. Department of Justice, to the Canadian Competition Bureau, and to more than thirty companies in the telecommunications, electric power, natural gas, mail delivery, and computer software industries in North America, Europe, Asia, and Australia.

3. I received A.B. and A.M. degrees in economics and a J.D. from Stanford University, where I was a member of the *Stanford Law Review*, and I served as a law clerk to Chief Judge Richard A. Posner during his first term on the U.S. Court of Appeals for the Seventh Circuit.

4. My name is Daniel F. Spulber. I am the Thomas G. Ayers Professor of Energy Resource Management and Professor of Management Strategy at the J. L. Kellogg Graduate School of Management, Northwestern University. I was previously Professor of Economics and Professor of Economics and Law at the University of Southern California. I have has also taught economics at Brown University and the California Institute of Technology. I have conducted extensive research over the last nineteen years in the areas of regulation, management strategy, industrial organization, microeconomic

theory, and energy economics.

5. I am the author of the textbook *Regulation and Markets* (MIT Press 1989). I have written two other books on the regulation of network industries, *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* (Cambridge University Press, forthcoming 1997) and *Protecting Competition from the Postal Monopoly* (AEI Press, 1996), both co-authored with J. Gregory Sidak. I have published more than fifty articles on regulation, pricing, management strategy, and related topics in numerous academic journals, including the *American Economic Review*, the *Columbia Law Review*, the *Journal of Economic Perspectives*, the *Journal of Economic Theory*, the *Journal of Law and Economics*, the *New York University Law Review*, the *Quarterly Journal of Economics*, the *RAND Journal of Economics*, and the *Yale Journal on Regulation*. I am the founding editor of the *Journal of Economics & Management Strategy*, published by the MIT Press. A recent survey ranked me sixth among the most prolific economists publishing in the leading academic journals.

6. I hold a B.A. degree in economics from the University of Michigan, and an M.A. and a Ph.D. in economics from Northwestern University.

7. We have been asked by the United States Telephone Association to evaluate whether the public interest would be served by the Commission's proposed changes in the determination of charges for interstate access. This affidavit draws upon and extends the analysis contained in our articles, "Deregulatory Takings and Breach of the Regulatory Contract," 71 *New York University Law Review* 851 (1996), and "The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements Under the Telecommunications Act of 1996," 97 *Columbia Law Review* (forthcoming 1997). We present this affidavit in our individual capacities, and not on behalf of the American Enterprise Institute, the Kellogg Graduate School of Management, or the Yale School of Management.

EXECUTIVE SUMMARY

8. We support and endorse the Commission's overriding goal in revising access charge rules—namely, to "foster competition for these services and eventually enable marketplace forces to eliminate the need for price regulation of these services."[1] We agree that access charges should be reformed, that competition in telecommunications should be allowed to proceed, and that regulation should recede as competition progresses. We have fundamental differences with the Commission, however, on the proper means to achieve its goal.

9. The Commission asks for guidance on choosing between two alternatives approaches to access reform. The first alternative is a market-based approach that would "let marketplace pressure move interstate access prices to competitive levels."[2] According to the Commission:

> This approach could be implemented incrementally, first eliminating certain regulatory constraints as incumbent price cap LECs demonstrate through credible, verifiable evidence that the conditions necessary for efficient local competition to develop in their service areas exist. Then, as incumbent LECs show that competition has emerged, additional regulatory constraints, including mandatory rate structures, would be eliminated to allow those LECs to adjust their interstate access rates. Finally, when substantial competition has developed, price regulation would be eliminated.[3]

The second alternative is termed a "prescriptive approach." Under this approach, the Commission "would require incumbent LECs to move their prices to specified levels and allow such LECs limited pricing flexibility until they can demonstrate they face actual competition for access."[4]

10. Superficially, the choice is clear. The "market-based approach" would appear to be superior because it would allow access prices to adjust to market forces and thus allow customers and suppliers of access services to respond to market incentives. That approach would also replace regulated prices with marketplace forces and thus achieve the FCC's overriding goal. Upon closer examination of the two choices, however, it is evident that the FCC is offering the incumbent LEC a choice between two

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1. *Notice* ¶ 140.
2. *Id.*
3. *Id.*
4. *Id.* ¶ 141.

highly imperfect alternatives, neither of which would achieve the FCC's goal. Indeed, the choices are mislabeled because the "market-based approach" entails *increased* regulation—even more regulatory controls than the so-called "prescriptive approach"—because of the Commission's set of four competitive triggers, which are a circuitous means of implementing the Commission's earlier objectives in the *First Report and Order* for the pricing of resale and unbundled network elements under sections 251 and 252 of the Communications Act.[5] Moreover, because the outcome of the two choices is ultimately the same in terms of access pricing, the FCC is offering the LECs a "heads I win, tails you lose" approach.

11. Our economic and legal analysis of access pricing reform yields nine principal conclusions. First, the Commission fails to make clear that the pricing of interstate access should be both efficient and compensatory. Prices for access should reflect the economic cost of origination and termination of long-distance communications, and those prices should be accompanied by competitively neutral, nonbypassable charges for the unrecovered portion of costs that the LEC has incurred to satisfy past and ongoing regulatory obligations.

12. Second, the Commission's competitive triggers have little to do with competition and everything to do with enforcing the agency's agenda for the pricing for resale and unbundled network elements under the *First Report and Order*. The competitive triggers prolong and increase regulatory intervention in the telecommunications marketplace. Those regulatory controls are not in the public interest because they would delay the benefits of competition and could derail the competitive process.

13. Third, the Commission's adoption of pricing for interstate access at total service long run incremental cost (TSLRIC) or total element long run incremental cost (TELRIC), plus a "prescriptive" share of common costs, would—unless accompanied by a competitively neutral, nonbypassable charge, such as one placed on interexchange carriers—guaranty that the incumbent LEC could not recover even

5. Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, First Report and Order, CC Dkt. Nos. 96-98, 95-185, 11 F.C.C. Rcd. 15499 (1996) [hereinafter *First Report and Order*].

its forward-looking economic costs.

14. Fourth, compelling economic and legal evidence supports the existence of a regulatory contract that obligates the Commission and the states to ensure that an incumbent LEC has a reasonable opportunity to recover *all* of its economic costs, both forward-looking and historic. Honoring the regulatory contract serves the public interest because it encourages LECs to make asset-specific investments to discharge their public service obligations.

15. Fifth, if the Commission or a state were to breach that regulatory contract, then the damages to which an incumbent LEC would be entitled would equal its lost expectation of the reasonable opportunity to recover its full economic costs. That standard contract remedy protects the incentives for LECs to make asset-specific investments in the local exchange network.

16. Sixth, pricing interstate access at TSLRIC or TELRIC, plus a "prescriptive" share of common costs, would deny the LEC any reasonable opportunity to recover its total costs. Consequently, the adoption of the Commission's pricing proposals for interstate access would constitute, under three separate strands of Supreme Court precedent, a taking of property in violation of the Fifth Amendment.

17. Seventh, the Commission's market-based approach would impose unconstitutional conditions on the incumbent LEC's ability to avail itself of the Commission's market approach to access reform. To qualify for the market-based approach, the LEC would have to acquiesce to the pricing rules proposed in the Commission's *First Report and Order* on interconnection. It is, however, the position of the incumbent LECs that those rules would produce uncompensatory prices and that the rules consequently violate the Takings Clause of the Fifth Amendment of the U.S. Constitution. Thus the Commission has essentially told the incumbent LECs, "If you don't want to have your interstate access charges promptly slashed to TELRIC or TSLRIC, plus some prescriptive allocation of common costs, then you must qualify for the market-based alternative by forsaking your constitutional claim to just compensation for the confiscation of private property that would be effected by enforcement of the *First*

Report and Order." The Commission cannot condition its grant of a government benefit on a party's surrender of a constitutional right.

18. Eighth, the Supreme Court's decision denying cost recovery in *Market Street Railway Co.* v. *Railroad Commission of California*[6] does not apply to the revenue shortfalls that incumbent LECs would suffer as a result of access "reform," notwithstanding the frequent citation of the case by opponents of stranded cost recovery. A regulated firm's loss of expected revenues due to regulatory change fundamentally differs from a regulated firm's loss of expected revenues due to changes in market conditions or technology.

19. Ninth, the incumbent LEC is entitled to recover all of its common costs (both forward-looking and historic), not just the portion that the separations process has labelled "interstate" or "intrastate." The state and federal governments would likely be jointly liable for the incumbent LEC's stranded costs under takings jurisprudence. Under a theory of breach of the regulatory contract, the relevant state or states would be liable for all of the LEC's stranded costs arising from the FCC's access "reform" measures if the federal government were successfully to shield itself from liability, under the doctrine of sovereign immunity, for breach of the regulatory contract.

I. Pricing Network Access

20. In regulation and public policy it is difficult to kill two birds with one stone. Network access pricing must satisfy two objectives: It must be efficient and compensatory. Efficient pricing requires that the prices for access to the telecommunications network convey the proper economic incentives in the marketplace to purchasers of access and other market participants. Compensatory pricing requires that access revenues allow the firm to recover its forward-looking economic costs and any other costs incurred in satisfying its past, current, and future regulatory obligations. It may not be possible to achieve those two objectives with a single policy instrument. If so, then regulators must use two policy

6. 324 U.S. 548 (1945).

instruments simultaneously: Access prices based on usage are needed to send the correct economic signals, and a competitively neutral and nonbypassable end-user charge is needed to allow the recovery of the costs that the incumbent LEC has incurred, currently incurs, and will continue to incur to meet its regulatory obligations.

21. The way to achieve the Commission's objective of securing "substantial competition for interstate access services" is (1) to allow carriers to price access competitively, and (2) to allow incumbent LECs to recover stranded cost through a system of competitively neutral end-user charges.

22. Competitive pricing of access means allowing prices to be adjusted by firms competing in the marketplace. It does not mean imposing prices by administrative fiat. Existing and projected facilities-based competition in the local exchange are sufficient to drive access charges to efficient levels. Even if such competition were not present, the availability of unbundled network elements under the sections 251 and 252 of the Telecommunications Act is sufficient to drive LECs' access charges to efficient levels. The LECs do not have an incentive to choose inefficiently high or inefficiently structured access charges for two reasons. First, a LEC has an interest in selling access to the interexchange carriers so as to make efficient use of its network for origination and termination of calls. Moreover, increasing facilities-based competition from CAPs and other competitive entrants will preclude inefficient and excessively high access pricing. Thus, both the availability of unbundled network elements and facilities-based competition allow ease of entry for the IXCs into the local exchange market. In response to the Commission's question about the mechanism for price adjustment, the competitive mechanism that will cause such adjustment to occur is nothing less than standard arbitrage by IXCs and other entering providers of local exchange service. Competition will motivate these service providers to choose the most effective, least-cost combination of unbundled elements and facilities to minimize their total costs of transmission, including access costs.

23. We agree with the Commission that prices for unbundled network elements should be